Antitrust Policy and the Republican Congress:
Vertical Integration and Vertical Restraints

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In ceasing to be largely an ideology and becoming largely a technique, antitrust has taken its place among a great many elements of our society that have become differentiated, specialized, and bureaucratized. Indeed, the business of studying, attacking, defending, and evaluating oligopolistic behavior and its regulation has become one of our lively small industries, which gives employment to many gifted professional men. No doubt this is [a]...reason why antitrust has become self-sustaining: it is not our way to liquidate an industry in which so many have a stake.

Richard Hofstadter

1 Introduction

The Republican Congress elected in 1994 came to Washington claiming a mandate to alter radically the scope and operation of the Federal government. In the past, new problems confronting government—problems which may themselves have arisen as unintended consequences of past programs—have generated new and ever more intrusive Federal responsibilities. Government has grown by accretion, so that while older problems may have waned, the programs spawned by those problems linger, piling up as government detritus. The cause of this failure to clear the debris of past policy interventions prior to embarking on new governmental initiatives is not difficult to discover. Government action commonly redistributes, providing beneficiaries with clear incentives to lobby for preservation of their benefits. As important, perhaps, as the pressure of beneficiaries, program implementors who receive a portion of the transfers while handling their distribution will be motivated to protect programs, a process nicely encapsulated by Hofstadter’s remark: “it is not our way to liquidate an industry in which so many have a stake.” The same view is a fundamental component of the Republican critique of government: “No government ever voluntarily reduces itself in size. Government programs, once launched, never disappear. Actually, a government bureau is the

nearest thing to eternal life we'll ever see on this earth!”² Yet the Republican Congress, belying its supposedly conservative inclinations, proposes not just to stand in the way of government growth, but actually to roll back the Federal bureaucracy. Programs that have either proven excessively burdensome or simply outlived their usefulness are to be downsized or eliminated altogether. The goal of this downsizing is to substitute reliance on personal responsibility and private institutions for government oversight. Where government functions are to be retained, this same reliance on individuals and disaggregated institutions is to be achieved by devolving Federal responsibilities to the States. This consignment is intended to locate regulatory responsibilities closer to the people and institutions to be regulated. The essence of the change the Republicans propose is thus to challenge exactly the sort of self-sustaining, institutionalized policy and bureaucracy that Hofstadter noted antitrust had already come to encompass even thirty years ago.

The antitrust activities of the Federal government have not been targets of the Republican reform movement. Concern about antitrust issues has arisen only in markets such as telecommunications and health care that have their own policy salience. But this may well change. The strictures of antitrust policy affect behavior not simply in a subset of market activity, but instead impinge upon the operations of every business firm large enough either to attract the attention of the antitrust authorities or to induce threatened competitors to seek their own antitrust protection. Although antitrust affects the economy generally, it is nevertheless remote and disconnected from those whose behavior it controls. This remoteness arises paradoxically from its populist origins. Viewed as responses to “do something” about concentrations of wealth arising from the growth of big business and about the economic inefficiency inherent in monopoly, the Sherman and Clayton Acts were little more than poorly articulated skeletons onto which the Department of Justice and the Courts were to attach the flesh and blood that would define the body of antitrust law. Even these open-ended statutes were models of specificity when compared to the Federal Trade Commission Act, enabling legislation for an agency, but not a policy. As a consequence, the antitrust bureaucracy

is separated from those whose behavior it attempts to control by a mass of complex rules that can neither be fathomed nor While clearly, inevitably political, antitrust is nevertheless without a political base. The sweep of antitrust policy, the lack of well-defined and enduring constituencies for antitrust regulation, and the complexity of the antitrust rules and theories that underlie them all conspire to make antitrust simultaneously intrusive, bureaucratized, complex beyond comprehension, and insensible to the needs and concerns of those it regulates. Robert Bork, writing twenty years ago, captured the seeming immutability of antitrust well: “In all kinds of political weather the machinery of antitrust enforcement grinds steadily on, mindlessly reproducing both the policy triumphs and disasters of the past. Even when public and political enthusiasm for the harassment of business is at an ebb, the enforcement bureaucracy and the residual potency of the antitrust symbol remain strong enough to prevent the law’s mistakes from being retracted.”

Those familiar with the history of antitrust policy will recognize that the very book in which Bork announced the impossibility of antitrust reform went a considerable distance toward nullifying his proposition. Just a decade and a year later, a book of economic analyses of antitrust disputes appeared with the title *The Antitrust Revolution*. The revolution celebrated was one of ideas. Economic analysis—price theory—came to infuse antitrust policy, altering dramatically the content of antitrust rules in ways that anticipate the approach of the new Republican Congress. Indeed, the Republicans could take heart in the receptivity of the bureaucracy and the courts to new ideas and to a change in focus away from reliance on government to new-found trust for private institutions, even if the legislature has been a bystander in the reform process.

But will antitrust once again be revolutionized? Do the Republicans in Congress have reason to attack the modestly resurgent antitrust bureaucracy and antitrust policy? Has bureaucratic recidivism since the last revolution been sufficient to warrant a new reform effort?

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5Both the relatively wide latitude for intellectual discussion to sway antitrust policy and the comparative neglect of that policy by the legislative branch may stem from the lack of clearly identifiable groups benefiting from antitrust.
Or will the focus of the antitrust laws on strengthening markets become even more salient as market-by-market deregulation increases the threat of monopoly? The task of this paper is to consider these issues in the context of antitrust policy toward vertical relationships. The birth of antitrust required a threat or set of threats to be countered—accumulation of economic power by the trusts and the threat of monopoly exploitation. In the matter of vertical relationships, similar threats exist today, particularly in emerging information technology markets. Powerful firms, simultaneously admired and feared, are moving to participate in new markets related vertically to their existing operations. Threats to competition can generate antitrust activity to regulate competition in such emerging markets, but can just as easily result in demands to free participants in these markets from government intrusion. The last revolution came not only from a sense that antitrust was excessively intrusive, but also from new ideas that provided a foundation for willingness to trust the marketplace to solve competitive problems. This suggests that we ask not only whether new threats exist that will require either extensions of or limitations on antitrust policy, but also whether new ideas are in place to generate, support, or compel such policy changes. Finally, one can ask whether in this limited policy context, the ideas energizing the new Republican majority give consistent, coherent results. Are the twin goals of downsizing government and returning power to the states compatible?

We consider these issues below. Section 2 asks whether new ideas in the analysis of oligopoly, ideas that have swept the economics profession, will serve as the basis for reform of antitrust policy. We conclude that while these new ideas may eventually have major, even revolutionary effects, their policy implications are not yet either sufficiently sharp or distinguished from current policy to do so. Section 3 discusses contradictions in the Republican approach to government reform in the context of policy toward vertical restraints, concluding that moving policy closer to “the people” may simply place that policy closer to those who can most readily profit from controlling policy determination. This can result in different policy, but not necessarily better, or even less regulation. Section 4 turns to the question of whether antitrust activity either initiated or contemplated will likely generate a significant reaction
from those who desire less intrusive government. In particular, we consider whether new markets will generate new pressure for stringent antitrust enforcement, or whether these new markets will instead lead to demands that antitrust get out of the way of the rapid changes which will continue to shake the marketplace. Section 5 offers concluding remarks.

2 Do Theoretical Innovations Favor Changes in Antitrust Policy?

In order to predict whether the pieces are in place for a substantial reshaping of antitrust policy, it is useful to consider the elements which controlled prior antitrust upheavals. In particular, the antitrust revolution of the 1980s required two related elements. Revolutions arise not merely from vague dissatisfaction with the contemporary environment, but from stronger distaste for events occasioned by overreaching of the accepted regime. Much as the Republican upheaval of 1994-5 reflects deep dissatisfaction with regulatory transgressions, egregious antitrust decisions were hardly rare during the 1960s and 1970s, and provided a ripe target for reformers. Proposals for breathtaking intrusions into the marketplace were seriously contemplated. But the catalog of bad decisions and the specter of more was insufficient—in the gambler’s phrase, one cannot beat something with nothing. A change in the intellectual climate was required. The something needed to buttress a turnabout in antitrust policy was economic analysis of market behavior. The “Chicago School” approach of viewing antitrust “through the lens of price theory,” came to dominate the antitrust landscape, and with it came a sharper focus on competition, not competitors, as the appropriate target of antitrust policy together with an increased appreciation of the robust defenses of the marketplace against monopoly dominance.

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6 Bork, supra n. 3, at 210, provides a large selection of particularly doubtful cases. He suggests that while it “would be overhasty to say that the Brown Shoe opinion is the worst antitrust essay ever written,” owing to stiff competition, “[s]hall, all things considered, Brown Shoe has considerable claim to the title.” See Brown Shoe v. United States, 370 U.S. 294 (1962). As a student of resale price maintenance, my personal, if parochial, favorite selection for antitrust ignominy is the Department of Justice criminal prosecution of Cuisinarts, Inc., United States v. Cusinarts, Inc., No. H80-49 (D. Conn. 1980).

7 The Chair of the Antitrust Subcommittee of the U.S. Senate Judiciary Committee introduced an “Industrial Reorganization Act” intending to break up many of the nation’s largest firms. This was a reflection of the recommendations of the 1968 White House Task Force on Antitrust, which had recommended that any firm with a market share of more than 15% in an industry with four firm concentration in excess of 70% should be broken up or forced to divest of resources to achieve a share of no more than twelve percent. Bork, at 6n and 176ff.
The tools of the Chicago-inspired antitrust revolution were in fact of considerable antiquity. Indeed, Chicago theorists competed with each other to trace their lineage most directly to Adam Smith. But even as antitrust policy was changing to reflect the primacy of economics, the underlying economic theory was beginning to experience its own revolution. Oligopoly theory, long dismissed as ad hoc and unconvincing, began to be infused with the new tools of Game Theory. Analyses without strategic elements became passé. Empirical work evaporated, with the exception of a few papers that provided at least nominal ties to the new theoretical approach. The leading graduate text in industrial organization is probably Jean Tirole’s The Theory of Industrial Organization (1988), the latter two-thirds of which are dominated by discussions of strategic behavior and the theory of games.

It may be an obvious question to ask whether this explosion of theoretical work will affect antitrust policy, but the answer is equally obvious. It must, and it will. Over the last decade and a half, the issues of oligopoly and strategic interaction have attracted the attention of the economics profession’s cleverest theorists. It would be surprising indeed if this intense concentration of talent had failed to yield important insights useful in understanding the markets populated by small numbers of firms that are the focus of antitrust. But will game theory serve as the underpinning for a new revolution, a radical change in direction from the Chicago approach? The answer here is much less clear, and awaits further theoretical and empirical developments. To see why, consider two aspects of the game theory approach.

The first is subgame perfection. Let two firms interact either actually or potentially with one another. Suppose that we find ourselves at a particular point in the life cycle of the market in which they operate. The rest of their interaction from that point on is termed a subgame. If the two firms have common and perfect knowledge of where they stand, of the strategies available to each, and of the forces that will affect each in the future, then decisions at any point of the subgame will reflect where each of the firms is at that time and where each can go in the future. How they got to that point does not matter. This result is simply a consequence of the economist’s claim that sunk costs are forever sunk, that past behavior that cannot be altered need not detain a rational decision maker. But the requirement that decisions at any point of
the interaction be optimal from that point on means that we can analyze complex dynamic interactions by working backward. Start at the end of the game. At that point, decisions made by each player must be rational given their current (end-of-game) circumstances. The dynamic aspects are gone, for only the last period matters. It is necessary to determine what each firm will do, and the payoff it receives in each state of the world that could possibly be arrived at. The analyst can then work backwards toward the current time period. In the second-to-last period, actions may be taken with an eye to the future, but future outcomes are now well specified. The firm in the second-to-last period will take actions designed to optimize the discounted value of its well-being in the final two periods, with the understanding that firms in the last time period will do what is best for them at that point. The analytical process continues working back to the present. The model’s solution to the question of what action to take today therefore depends not only on the current consequences of today’s actions, but also upon (rationally anticipated) future optimization by all parties.\footnote{The computational effort needed to determine such equilibria have caused some game theorists to consider alternative methods for decision making. One alternative is that decision makers may rely on reputation and past experience to determine similarities between options today and past outcomes of decisions. For an example of this inductive approach, see Itzhak Gilboa and David Schmeidler, “Case-Based Decision Theory,” Quarterly Journal of Economics, vol. 110 (August 1995): 605–39.}

Subgame perfection means that to be taken seriously today, threats about what a firm might do tomorrow must be credible. If one firm threatens a price war that will, if it comes to pass, hurt the firm initiating the war as much or more than its intended targets, the threat will not likely be exercised and can be discounted. The subgame perfection approach provides an important tool for studying dynamic interactions. The results of such studies are not, however, incompatible with Chicago-style thinking about antitrust issues. Indeed, the insistence that threats be credible, and that firms be treated as rational, forward-looking profit maximizers formalizes Chicago objections to claims of predatory pricing and erection of entry barriers. Game theory provides a rigorous justification for much Chicago-style reasoning. As one of its most graceful advocates puts it, “The first and perhaps the most important role that game theory plays in economic analysis comes in the formulation and framing of issues.”

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allow analysts to see how such intuitions can be applied in fresh contexts and permit analysts to explore intuition in and extend it to slightly more complex formulations of situations."

Game theory is often criticized as abstruse, complex, and unrealistic. But in fact, when done carefully and sensitively, it provides a reality check for intuition, a way of ensuring the logical consistency of common sense. It helps us to understand both the power and the limitations of earlier ideas. But this is not the making of a dramatic break with the past.

To see the complementarities between the Chicago School approach to antitrust and subgame perfection, consider the Kodak decision. One commentator’s rather gleeful interpretation of Kodak is summarized in his title, “Chicago Takes It on the Chin.” In Kodak, the Supreme Court ruled that the market for service of Kodak copiers was distinct from that for the copiers themselves. This ruling makes sense only if customers are myopic in those initial decisions, ignoring the costs that can be imposed on them once they lock themselves into a particular brand of copier. Without this myopia, competition at the copier level is directly relevant to the service market, for even if customers cannot prevent exploitation in the future, firms will offer lower prices on copiers today in order to be able to access those future rents. The Kodak decision was no more a rejection of Chicago than it was a rejection of the subgame perfection approach.

While the techniques of game theory involving subgame perfection tend to complement and support the work of the Chicago school, it is of course true that situations with far less than common and perfect information are the norm in the marketplace. Game theorists have shown that concerns about predation, entry deterrence, signaling, limit pricing and the like can be resurrected in the presence of imperfectly informed market participants. Clever analyses have shown that rational, profit-maximizing firms can take advantage of mistakes in the market or irrationality by others to achieve valuable reputations for toughness, reputations which may mislead rivals about what the firm would actually do when confronted with a rival. Such

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firms’ actions magnify errors and irrational behavior as rational firms may find it quite sane to appear crazy. But these approaches, while clever, are not likely to yield clear implications for policy any time in the near future. The reason is that once such imperfections are admitted to the analysis, the range of possible consequences is breathtakingly wide. The analyst gains an embarrassment of riches as too many possible outcomes result in too little guidance for policy.

Suppose that two firms choose prices over a long period of time, observing each others actions and reactions. Can they learn to collude without actually communicating with one another? Can they find themselves locked in unending competition in which each is reduced to what it could get if it took its resources and went elsewhere? The answer, according to the common wisdom of game theory termed the folk theorem, is that each of these solutions, competition and monopoly, as well as everything in between, is sustainable as an equilibrium of their game. That is, any solution that is simultaneously feasible and individually rational (as good as outside alternatives) can be an equilibrium, provided that the future is sufficiently important to the firms. The folk theorem is liberating for economists wishing to offer policy advice in particular cases. Since in theory, virtually anything can happen, the analyst can provide a “story” to fit the facts of a particular case with confidence that an underlying equilibrium model can be constructed to fit that story. Predation can be resurrected, tacit collusion becomes possible, firm conduct can plausibly be interpreted as designed to deter entry. But since alternative, competitive equilibria are also supportable in the same way, definitive policy prescription is not possible. Rules must give way to case-by-case decision making. Whether this is an improvement over the certainties of the Chicago school approach is debatable, but it is difficult to imagine a new umbrella of antitrust policy supported by theoretical ribs, each of which is labeled “anything can happen.” The new game theoretic approach may yield suggestions about market institutions, trading rules, and the like that can contribute to firms’ ability to reach a monopoly or near-monopoly solution. By opening an infinite realm of possibilities, dynamic game-theoretic analysis is immensely liberating to aggressive antitrust enforcers. But without definitive results, game theory is not likely to play more than a supporting role in fa-
cilitating actions enforcement agencies would like to pursue. The possibility that game theory will itself result in new suggestions for the development of antitrust policy is remote. In any event, to the extent that game theory liberates government to interfere more extensively in the marketplace, it goes counter to the Republican approach demanding not liberation for government policy, but rather from policy intervention.

This discussion has considered game theory generally rather than its application to vertical restraints and vertical integration. A recent paper by Riordan and Salop has addressed the link directly.\textsuperscript{13} As suggested above, to the extent that Riordan and Salop apply the tools of game theory to the analysis of vertical mergers, the effect is to expand the range of possibilities to be analyzed. They provide a list of problems that can arise and then proceed to recommend that antitrust authorities check initially to see if a vertical acquisition of an input supplier will lead to foreclosure or increased input prices to downstream rivals. Their suggestions about how to accomplish this task are vague, however, and little illuminated by the game theoretic models they claim call for such an investigation. Without careful consideration about how theory might guide decisions by antitrust authorities, the Riordan-Salop post-Chicago approach looks remarkably like the pre-Chicago case-by-case approach, an approach that has been firmly, and justifiably, rejected. Perhaps the point is just that, to argue that opinions cast on the antitrust ash-heap can arise Phoenix-like, resurrected by theoretical innovations. At the current time, however, such a resurrection seems to depend more on faith in the old-time antitrust religion than on innovations in theory.

3 Vertical Restraints

Contemplation of potential changes in antitrust policy toward vertical restraints tells us less about what the Republican Congress might do than it does about important contradictions inherent in the Republican reform agenda. Vertical restraints are contractual restrictions through which manufacturers attempt to control the actions of the downstream dealers and

distributors of their products. Such restraints include exclusive territories, distributorships, and dealerships, and customer restrictions, each of which limits the ability of dealers to compete with one another; resale price maintenance arrangements under which a manufacturer attempts to control the price at which its products are resold to consumers; and exclusive dealing, a dealer’s agreement not to handle rival products as a condition for being granted the right to sell the manufacturer’s line. Antitrust policy governing use of vertical restraints has shifted from sharp hostility during the 1970s to the contemporary norm of benign neglect. Non-price vertical restraints such as territorial or customer restrictions and exclusive dealing are subject to very tolerant rule of reason standards, standards where the presumption of reasonableness lies with the contracting parties. Resale price maintenance remains nominally per se illegal, but firms which wish to control resale prices may do so if they content themselves with announcing their desired prices and terminating offending dealers. With Federal approbation for minimum advertised pricing plans, manufacturers can put significant monetary incentives in place to ensure compliance with their desired resale prices. Manufacturers are simply prohibited from entering into explicit agreements with dealers to maintain resale prices.

The Republicans propose generally to devolve federal functions to the states, thereby bringing the regulations closer to those to be regulated, presumably replacing bureaucratic arrogance and isolation with sensitivity and common sense in implementation. Yet placing the regulatory locus closer to the regulated need not be a recipe either for less or for better regulation. Placing the regulations closer to “the people” would seem to assume that “the people” speak with one voice. If instead, those people most directly affected by the regulations in question are the loudest, they may well get the bulk of policy makers’ attention. Public choice theory suggests that the results may be to steer regulatory outcomes toward those desired by the regulated firms. The FTC’s remoteness from the firms it is charged with regulating could be a boon, not a bane, at least to the extent that demand for its regulatory activities ensures that some form of regulation will continue at some level of the federal system.

To see why this may be the case, consider the curious evolution of the regulation of manufacturer-dealer relations. We have noted that the antitrust attitude toward vertical restraints is generally lenient, and that even the continued status of RPM as per se illegal does not prohibit manufacturers from unilaterally implementing the practice. The antitrust roll-back of hostility to vertical restraints began with GTE-Sylvania\textsuperscript{15} in 1977. It continued in the 1980s with ever more permissive court decisions and the publication of Department of Justice Vertical Restraints Guidelines for non-price restraints, and with minuscule Federal interest in seeking resale price maintenance cases combined with permissive court decisions such as Business Electronics.\textsuperscript{16}

In contrast to this trend toward antitrust deregulation of manufacturer-dealer relations, both the Congress and the states have passed regulatory statutes increasing control over such relationships. Automotive manufacturers are commonly prohibited from establishing new dealerships uncomfortably close to existing dealers, and termination of dealers has become much more difficult.\textsuperscript{17} Gasoline refiners are also limited in the control exercised over their stations by the Petroleum Marketing Practices Act\textsuperscript{18} and by state statutes. Other market-specific franchise rules are often in place covering the marketing of alcoholic beverages and farm implements.\textsuperscript{19} Finally, at least seventeen states have passed franchise regulations which control franchisor-franchisee relations more stringently than the modest regulations of the Federal Trade Commission.\textsuperscript{20} While some of these statutes deal primarily with disclosure rules designed to protect prospective franchisees, others limit the ability of franchisors to terminate franchisees or to locate new franchise operations close to established franchisee

\textsuperscript{16}Business Electronics Corp. v. Sharp Electronics Corp., 485 U.S. 717 (1988), holding that a dealer may be terminated following complaints from a rival that it cut prices, so long as the manufacturer and remaining rival do not agree to set resale prices at a specific level.
\textsuperscript{18}15 U.S.C. @2801–2841 (1982).
\textsuperscript{19}The Soft Drink Interbrand Competition Act is a special piece of legislation permitting latitude to manufacturers in establishing territories for dealers. It facilitates vertical control by syrup producers over their bottlers, and thereby runs counter to the thrust of the automobile dealer, gasoline station, and franchise regulation. It was passed in response to state and antitrust limitations on manufacturer freedom of action. Such pieces of legislation are far less desirable than sensible antitrust policies consistent across markets and industries.
locations. These rules are apparently not the result of states filling gaps caused by weakening antitrust restrictions on vertical restraints. The bulk of the state franchise statutes were passed during the 1970s, when most courts were willing to consider at least some fairness factors in analyzing vertical restraints under the antitrust laws. 21

There can be little doubt that these new enactments are anticompetitive in nature. 22 Designed to ensure fairness in manufacturer-dealer relations, they protect franchisees much as antitrust policy has in the past attempted to protect competitors. In political battles to adopt such legislation, one can expect manufacturers and franchisors to be pitted against dealers and franchisees, with consumers little represented. By causing such battles to be fought at the state, rather than the federal level, it is likely that the relative strength of franchisees will be enhanced, at least in some cases.

Iowa’s franchise regulation is a particularly clear manifestation of the political forces at work. Iowa has passed the nation’s most restrictive statute governing franchisor-franchisee relations. 23 The statute has been vigorously opposed by leading franchisors such as McDonald’s, and franchisor interests have spent large sums to put their case forward. 24 Their lack of success is not surprising, however, for Iowa possesses virtually no important franchisors. As in the nation as a whole, franchisees are common and vocal. 25

The Iowa experience illustrates the benefits of FTC isolation. With no single group of franchisees able to bring determinative pressure to bear at the federal level, and with franchisers possessing both means and incentive to counter franchisee pressure, the result is much more likely to be a standoff, with less likelihood of anticompetitive results. Nevertheless, this benefit would be modest in this case, for as noted above, the onset of franchise statutes predated the change in the antitrust treatment of vertical restraints. In addition, the presence of Federal regulations of dealer relations has not more restrictive state standards.

21 Burns, id.
23 1992 Iowa Legis. Serv. 2362 (West).
25 I thank Francine LaFontaine for stressing this point.
The second response to changes in Federal antitrust policy has been to energize the states to take a more active role in enforcing vertical restraints rules. The state attorney generals have experienced success in prosecuting Japanese appliance manufacturers for resale price maintenance. States played a leading role in two of the leading RPM cases of the 1990’s, Reebok and Nintendo. The state NAAG Vertical Restraints Guidelines call for much more aggressive enforcement than their (now withdrawn) federal counterparts. One lesson to be drawn from this aggressive response may be that Republicans are less inclined to pursue vertical restraints use, as many of the states involved in multistate antitrust litigation have had Democrat Attorney Generals. This impression is reinforced by congressional experience. In 1991, Democrat-led attempts to strengthen the law against resale price maintenance were frustrated by an amendment introduced by Republican Tom Campbell. When the amendment was dropped in House-Senate Conference, the House took the unusual step of rejecting the conference report.

Unlike the case of franchise regulation, the growth of state involvement in multistate vertical restraint actions is clearly a response to the diminished federal activity in this area. This does suggest a clear party delineation in this area, and the likelihood that should federal enforcement become more energetic, a Republican Congress could react with displeasure. In addition, however, the question of the appropriate level for antitrust activity is once again raised. Antitrust policy should be expected to provide clear and coherent signals to firms about what they can and cannot do. Dividing that responsibility between federal and state enforcement is hardly a recipe for coherence. One way to rationalize responsibility would be to de-emphasize federal enforcement, relying on states to bring cases against practices deemed most harmful to their citizens. Two factors argue against this approach. First, the states have tended to cooperate in multistate actions, thereby duplicating the federal role. If enforcement is indeed to be national in scope, then it makes sense to place responsibility for that

enforcement at the level of the Federal government. Second, while the states have substantial resources for investigation and litigation, it is unlikely that the states can match the economics talent of the staffs of the Federal agencies. While there is precedent from other policy areas for states to pool research resources, a new and duplicative institutional structure would be required to do so. Professional staff economists can play a valuable role in case selection and case development, placing a check on excessive litigation. In contrast, economists hired as consultants are much more likely to have a stake in the continuing prosecution of cases of dubious value.

What lessons may we draw from this? Shrinking the federal antitrust responsibility may create state-level political pressure to fill the void, either through increased enforcement activity or through compensatory regulation, regulation that may be more directly attuned to the interests of the parties most directly affected by the regulations. For non-price vertical restraints, the states appear to have been more interested in helping particular competitors than in fostering competition. On the resale price maintenance side, states have moved aggressively to fill the gaps caused by decreased Federal activity. Whether this improvement is desirable depends on one’s view of the appropriate policy toward RPM, but in any event, it seems fair to say that economics has not and will not play as important a role in state enforcement activity as it has at the Federal level. For an economist, this result is, not surprisingly, undesirable.

Before turning to vertical integration, it is useful to note that the logic of vertical restraints analysis is likely to play an important role in discussions of policy reform for the health care sector. Here, the partisan battlelines will likely be clearly drawn. Consider the vertical restraints problem. Vertical restraints are exclusionary. They place limitations on competition, limitations that may be necessary to permit private formation of property rights to enable

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30 Ohio State, for example, is home to the National Regulatory Research Institute, a “think-tank” funded primarily by state public utility commissions.

31 Even were the Congress to turn its attention directly onto vertical restraints matters, it is difficult to predict what sorts of actions would result. The anti-regulation message of the Republicans suggests reduced enforcement and a more permissive stance toward use of vertical restraints. However, to the extent that small business wishes to reign in the contractual freedom of big business partners, the results could be reversed. The new Republican majority has a decided small business orientation in comparison to past Republican positions. See David E. Sanger, “The Big One: Washington’s Political Earthquake; Seismic Shift In the Parties Reflects View on Business,” New York Times, September 24, 1995, Section 4, p. 1.
private policing of the marketplace. Such limitations are the source of antitrust objections to vertical restraints use. Health care, of course, demands extensive policing, as the informational requirements consumers face individually are nearly insurmountable. policing. The move toward managed care requires that health care coverage organizations must monitor care carefully, pitting providers against one another, denying to any who provide either inadequate quality or excessive prices access to the customers they represent.

Antitrust reform for the health care sector will clearly be a Republican priority in the new Congress.\textsuperscript{32} To the extent that the relief offered extends from mergers to exclusionary practices, developments in this sector will need to be reconciled with those for vertical restraints generally. If so it is difficult to imagine more stringent rules on vertical restraints finding favor on Capitol Hill.

4 Vertical Integration

As we argued in Section 2 above, the changes in antitrust policy in the 1980s required more than simply a firm intellectual basis. The price theoretic underpinnings of those changes might not have had a major impact were it not for a growing and more visceral sense that the antitrust enterprise was off course. Competition in the U.S. market hardly seemed insufficient. The Kennedy Round and Tokyo Round tariff cuts had resulted in an explosion in international trade.\textsuperscript{33} Firms in highly concentrated domestic industries such as automobile manufacturing and electronics faced daunting competition from foreign rivals. The benefits of antitrust intervention designed to stimulate competition in such industries were correspondingly reduced. Moreover, the threat to competition posed by large, powerful domestic firms was made less credible in proportion to the success of (typically smaller) foreign rivals in penetrating U.S. markets. Bigness was becoming as much an indicator of ponderousness as of power. Yet many

\textsuperscript{32}See, for example, Marilyn Werber Serafini, “He'll be Taking the House's Temperature,” National Journal, April 22, 1995.

\textsuperscript{33}Between 1970 and 1980, U.S. general imports tripled in real terms. An important component of this growth was a very rapid rise in petroleum imports, but even when petroleum is netted out of the calculations, real imports more than doubled during the decade. Calculations based upon data reported by U.S. Bureau of the Census, Statistical Abstract of the United States: 1994 (114th ed.), Washington, DC, 1994.
of the excesses of antitrust had been based upon the notion that competition required both governmental nurturing and protection from aspiring monopolies. With this threat devalued, it became easier to believe that rather than protect the public from the alleged excesses of unfettered competition, economic efficiency and market dynamism were themselves at risk from excessive intrusion by antitrust policy.

The birth of the antitrust movement had also required a threat, fear that rapid change was concentrating not only market share, but far more ominously, wealth, power, and control over the future in too few hands. The specter of the trusts run amok, personified by powerful figures like John D. Rockefeller, was enough to jump-start the antitrust express. That is, the two greatest changes in antitrust policy, its birth and the 1980s reform were both borne of deep dissatisfaction with the contemporary marketplace, but differed in their diagnoses of the problem and, accordingly, of the appropriate solution. The first antitrust revolution was the result of fear of industrial dynamism and market change, while the recent revolution arose from a new-found appreciation that competition requires winners and losers, so that the rough and tumble of the marketplace was not a vice, but a necessary condition for economic efficiency.

In the 1990s the nation once again confronts rapid change as the much-publicized information age dawns. Industrial dynamism has already proven unsettling to many Americans, with foreign competition ever threatening, and with industrial restructuring and downsizing reducing economic security. But one important market is growing rapidly and does not face the check of foreign competition. Within the information marketplace, the combination of large market participants and seemingly insurmountable network economies threatening to render one product after another a natural monopoly is remarkably reminiscent of the emergence of the trusts and their market dominance. The new players, whether actual or potential, are as remote, as strange to many of us as the leaders of the trusts were to our forefathers. From the faceless providers of local telephone service—the regional Bell operating companies (RBOC’s)—to the media conglomerates, to the cable and cellular giants, we see very large and remote firms jostling for position in the new information world. The central player in the
emerging markets, seemingly with ambitions to control the entire information marketplace, is Microsoft. In one company we have united the power of Standard Oil and the market dominance of Big Blue IBM, run by William Gates. Gates, portrayed in the press as a one-time child wonder, a Harvard drop-out and techno-nerd, surely is as alien to many of us as Rockefeller could ever have been to his contemporaries.34

With antitrust confronted by Microsoft, the RBOC’s, cable, cellular, and media giants, aspiring monopolists all, the basic question for policy is whether competition may be relied upon, or whether intervention is required. The firms facing off in this market come from a wide variety of industry structures, each of which provides a power base. One must ask whether it is better to permit these firms to compete so that each attacks and erodes the monopoly power of the others, or such competition would replace an existing series of monopolies in currently distinct markets with a single, much more powerful monopoly firm. It is here that the largest philosophical battles over the soul of antitrust will be fought, and the battle lines are becoming clear. Antitrust has stood in the way of market dynamism, holding back the RBOCS, though time and technology appear to be conspiring to put an end to this era.35 Instead we have Microsoft at the new bogeyman, The Antitrust Division of the United States Department of Justice has already affected Microsoft operations in two actions, and threatens to do so in a third matter. These actions have the potential to return antitrust policy to a regime where fear of future competitive problems is sufficient to justify current competitive restrictions. That is, it is possible that such actions may once again cause large firms to hold their competitive impulses in check, nurturing competitors at the expense of competition. But as in the past, this regime could well provoke a reaction, energizing the opposition to antitrust as a tool to restrain competition.

We now have a clear sign of where the Republican congressional leaders stand on this issue.

34The Economist dubbed Gates “smarter than most tycoons, richer than several small countries, and as powerful as any minor deity...” But perhaps Rockefeller is not the appropriate comparison: “certain White House officials refer to him as ‘the Jay Gould of the information age.’ ” See “Bill Gates and the open road,” The Economist, June 3, 1995, p. 29.
Senate Majority Leader Robert Dole has called the Antitrust Division’s pursuit of Microsoft “out of control.” Dole’s House of Representatives counterpart, Speaker Newt Gingrich, is even more supportive of Microsoft, and it specific in his antitrust concerns:

Gingrich said antitrust arguments fail when tested against the economics of the information age. Specifically, he addressed the theory that Microsoft tried to buy its way into a monopoly of online banking through Intuit, Inc.

“It is an industry that does not yet exist, with a service that is not yet offered to customers who don’t get paid. We already think it is a monopoly,” he said.

“I think the whole antitrust argument is nuts. I think you live in a world market of enormous technological change. And your potential for creating an embedded monopoly—it one shows up, I would be glad to hold hearings on it,” he added.

According to press reports, Microsoft has been the target of three recent, distinct antitrust inquiries. The first governed its marketing practices for operating systems software. The operating system is the most elemental software component in a computer. It constitutes a layer between the computer’s application software and its hardware, accepting instructions from the former and translating them into requests the latter can understand. It parses such instructions, rejecting any that do not conform to its rules, and when necessary mediating among conflicting requests from various operations. Microsoft sells the operating system used by so-called IBM-compatible personal computers. This system has evolved considerably over time from a very simple system (called MS-DOS, or when sold by IBM, PC-DOS) to a much more capable system known as Microsoft Windows (now including Windows NT and Windows 95).

While other operating systems such as OS/ 2, NextStep, and various flavors of Unix are capable of controlling the same computers that use Microsoft systems, most applications software is written with instructions that only Microsoft operating systems can interpret correctly, and hence Microsoft dominates the large and growing personal computer market.

Microsoft was charged with pricing its operating system software for the purpose of barring rivals from competing with this core part of the computer system. It was accused of

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38 “CA DC Orders Approval of Microsoft Consent Decree by Different Judge,” 68 Antitrust and Trade Regulation Report 807, June 22, 1995.
employing a variant of take-it-or-leave-it pricing, charging computer manufacturers for all systems shipped, whether a system shipped with a Microsoft operating system or that of a rival. With unchallenged control over the essential intermediary between applications programs and the computer hardware that turned instructions into action, Microsoft could insert new instructions at will, favoring its own applications software businesses. It could rewrite instructions, causing older programs to fail on new systems. In some formulations, Microsoft was also accused preannounce new capabilities of the operating system revisions far in advance of release, thereby disadvantaging competing OS vendors, though clearly such preannouncement of intentions, capabilities, and instructions would be in the interest of rival applications vendors.

The Antitrust Division entered into a consent decree at addressed only the first of these issues, a decree that has been criticized as weak and unlikely to alter Microsoft’s ability to exclude rival OS vendors. The decree requires that Microsoft license its system to computer hardware manufacturers by charging fees per computer shipped with the software included, as opposed to demanding “per processor” payments for each computer manufactured. By raising the marginal cost to a manufacturer of shipping a Microsoft product, this change in pricing was intended to increase the ability of rival operating system providers to compete.

While advantages that Microsoft’s control over operating systems might offer its applications software developers raise vertical issues, the requirement that Microsoft charge per copy did not. It is worth noting, however, that forcing a change in marketing policy can be expected to have adverse efficiency consequences. The cost of software is almost entirely up-front. Microsoft provides computer manufacturers with a single copy of the software and manuals (in electronic form). The marginal cost to Microsoft should a manufacturer ship an additional system with Microsoft’s software is therefore essentially zero. Efficiency is served by Microsoft charging a fixed fee plus marginal cost, which is what its previous policy accomplished. The consent decree prohibits this pricing, forcing higher marginal costs on computer manufacturers. Since the benefits to flow from the consent decrees are expected to be negligible, a

Note that rival software manufacturers could also offer fixed price contracts. The Justice Department actions could benefit rivals in the same way that forcing Ford to charge more for automobiles would benefit Chrysler,
benefit-cost analysis of the Justice Department's actions is not apt to yield a favorable result. The Justice Department's more recent dealings with Microsoft have been more vertical in character, and more distressing. Microsoft's attempt to purchase Intuit, the leading manufacturer of personal finance software, was challenged on both the horizontal ground that it would eliminate competition between the firms in personal finance software, and on the vertical ground that it would reduce competition in the nascent home banking market. More recently, DOJ has been investigating a not-yet-introduced Microsoft service, Microsoft Network, that would be bundled with its upcoming Windows 95 software. Microsoft Network would compete with large, well-established computer network service providers such as Prodigy, America OnLine, and Compuserve. By bundling its network with its operating system software, Microsoft would thereby offer consumers a seamless installation process and a very convenient way of connecting to a network. Customers, it is feared, would find this ease of connection so attractive that they would sign up in large numbers, thereby reducing prospective added revenues for incumbents. Of course, existing customers of the incumbents would not defect unless Microsoft Network offered superior content to its rivals, but that could happen as well if the new network were able to access substantial network economies. The power of such economies can be questioned, however, for if they were indeed overwhelming, one would predict that the marketplace prior to Microsoft's entry would be dominated by a single firm, contrary to fact. That is, the market for networked information services either is or is not a natural monopoly. If it is, keeping Microsoft from entering it only delays its eventual dominance by some other service provider. If it is not, then holding Microsoft on the sidelines reduces competition and increases consumers prices. However, in the Intel-based personal computer market dominated by Microsoft, few Chryslers are in the offing. The principal challenger, OS/2 from IBM, has failed to provide performance advantages, network functionality, and ease-of-installation sufficient to attract a significant following outside of large corporate customers. IBM, a leading manufacturer of personal computers, was surely not deterred from developing its own system by Microsoft marketing practices. It is ironic that IBM, previously viewed as possessing unassailable power over the computer industry, is the principal potential beneficiary of the Department of Justice consent agreement. Notice the similarity of Microsoft's practices to those of IBM in that earlier era of dominance. Indeed, IBM controlled both hardware and software, exerted more dominance than Microsoft, and yet still was unable to defend its dominant position from new entrants. Though deeming the result a victory for consumers might be difficult. However, in the Intel-based personal computer market dominated by Microsoft, few Chryslers are in the offing. The principal challenger, OS/2 from IBM, has failed to provide performance advantages, network functionality, and ease-of-installation sufficient to attract a significant following outside of large corporate customers. IBM, a leading manufacturer of personal computers, was surely not deterred from developing its own system by Microsoft marketing practices. It is ironic that IBM, previously viewed as possessing unassailable power over the computer industry, is the principal potential beneficiary of the Department of Justice consent agreement. Notice the similarity of Microsoft's practices to those of IBM in that earlier era of dominance. Indeed, IBM controlled both hardware and software, exerted more dominance than Microsoft, and yet still was unable to defend its dominant position from new entrants.

42 In any event, it is hardly clear that any proprietary network provider will be able to dominate the information
Long-time students of antitrust will recall the issues in these investigations from older antitrust cases. The need to protect established competitors from new rivals brings Utah Pie to mind. Of course in Utah Pie, one incumbent firm was to be protected from three, rather than the other way around, but at least the rivals had managed actually to enter the marketplace before generating antitrust scrutiny. The fear of future adverse consequences from actions that would strengthen current competition suggests Von’s. The horizontal aspects of the Intuit matter are reminiscent of Proctor & Gamble. Yet the Microsoft cases evoke no case more richly than Brown Shoe. The principal objection to Microsoft’s aggressive extensions of its core business in operating systems appears simply to be the possibility that these extensions might prove to efficient, too compelling to customers for rivals to be able to compete effectively. There is no suggestion that Microsoft intends to lose money in order to drive out rivals, eventually recouping its losses through monopoly profits. Instead, the fear is that the company simply might be too good at designing and marketing a new, attractive, and important set of services. If antitrust policies nod once again in the direction of protecting competitors from the rigors of competition, the likelihood of a reaction against antitrust activity is greatly increased.

5 Concluding Remarks

How, then, will the Republican Congress affect antitrust? To answer this question, one must first answer the prior question of what course the antitrust authorities will choose. In the area of vertical restraints and particularly in that of vertical relationships in telecommunications markets, the authorities appear bent on a strategy of aggressive efforts to shape the marketplace, rather than simply reacting to developments that do prove to limit competitive market vitality. But by choosing a proactive stance, antitrust policy makers increase the likelihood

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43 See Ward S. Bowman, “Restraint of Trade by the Supreme Court: The Utah Pie Case,” 77 Yale L. J. 70 (1967).
of a congressional reaction, one which may well result in attempts to combine the agencies, scaling them back in the process. This may not be a particularly propitious time for an agency to bring attention to its aggressively interventionist tendencies.